Major Energy Users Inc.

18 March 2021

The Commissioners
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Sent to: AEMC by online lodgement

Dear Commissioners

Financeability of ISP Projects
Response to Draft Rule Decision
ERC 0320 and ERC 0322

Major Energy Users Inc (MEU) is pleased to provide its thoughts on the issues raised in the Consultation Paper for rule change proposals to change the approach to revenue recovery from ISP projects carried out by TransGrid and ElectraNet.

The MEU was established by very large energy using firms to represent their interests in the energy markets. With regard to all of the energy supplies they need to continue their operations and so supply to their customers, MEU members are vitally interested in four key aspects – the cost of the energy supplies, the reliability of delivery for those supplies, the quality of the delivered supplies and the long-term security for the continuation of those supplies.

Many of the MEU members, being regionally based, are heavily dependent on local staff, suppliers of hardware and services, and have an obligation to represent the views of these local suppliers. With this in mind, the members of the MEU require their views to not only represent the views of large energy users, but also those interests of smaller power and gas users, and even at the residences used by their workforces that live in the regions where the members operate.

It is on this basis the MEU and its regional affiliates have been advocating in the interests of energy consumers for over 20 years and it has a high recognition as providing informed comment on energy issues from a consumer viewpoint with various regulators (ACCC, AEMO, AEMC, AER and regional regulators) and with governments.

The MEU stresses that the views expressed by it in this response are based on looking at the issues from the perspective of consumers of electricity and it has not attempted to provide any significant analysis on how the proposed changes might impact other stakeholders.

The MEU is aware there is increasing pressure to expedite the augmentation of networks (especially those augmentations identified through the ISP) and to address perceived restrictions in the RIT process. The MEU considers that these pressures should not influence the process for making sensible fact-based decisions about network augmentations (and the NEM more widely) and ensuring the long-term interests of consumers are actually achieved through careful and considered debate and analysis. The MEU points out that the decision to invest in new major transmission augmentations will incur considerable capital cost which will be recovered over a 50-60 year window in time. Once the investment is made the costs are sunk with NSPs guaranteed a return on the investment, yet the benefits are based on assumptions about the future (and so somewhat nebulous), and will take decades to be delivered, if ever.

Further forecasting of benefits is effectively based on known technology, yet even within the 20 years operation of the NEM, assumption on future needs of the electricity market have changed dramatically, over-turning many of the assumptions made even within the last decade. This means that the process for investing massive amounts in long lived assets (such as transmission interconnectors) need to reflect this reality of very rapid change. So, any decision to invest needs to be made in full understanding and acceptance of this reality to ensure that consumers now and in the future are not having to pay off assets that do not operate at full capacity, or even become redundant before they have returned the benefits needed to make the investment viable.

With these thoughts in mind, the MEU does not consider it is necessary or appropriate to make it easier for proponents of investments to change the rules to reduce the risk of they face when making investment commitments. The MEU sees the current rules already minimise the risk of network investment and provide a reasonable balance between the interests of investors and the long-term interests of consumers.

As the MEU provided a view in its response to the consultation paper on this topic that neither of the changes should be made, the MEU supports the AEMC draft decision there is no need to change the current rules and that no new rule should be made in response to the applications from TransGrid and ElectraNet for a new rule to allow earlier recovery of investment or for the allowed revenue to be assessed on the basis of actual depreciated investment multiplied by a nominal cost of capital[1].

The AEMC draft decision provides clear and succinct reasoning that the proposed changes should not be implemented, and this is backed up by the cogent assessment of the issue provided by AEMC consultant, CEPA.

The MEU does point out that the AEMC and CEPA assessments did not address the temporal realities that the regulatory framework provides a basis for assessing revenue over the long term, reflecting the actual recovered revenue in each year might be lower or higher than the expectation. The MEU considers that a debt provider will look at the

[1] That is, as an alternative to the current process which calculates allowed revenue on the basis of a depreciated replacement cost multiplied by a real cost of capital.

longer-term revenue stream and of its certainty of occurring than what might occur on an annual basis or even a single regulatory period. The MEU notes that to some extent this issue is addressed in the modelling by CEPA even though the CEPA modelling was based on the expected revenue in each year.

The AEMC (and CEPA) rightly point out that there are clearly two and divergent aspects in play regarding the proposed rule change – firstly that AER only looks at what financial structure a "pure play benchmark efficient entity" (the BEE) requires to provide the network services required by consumers and secondly, that actual networks can develop whatever financial structure they desire, including the incorporation of unregulated activities. In this regard, the MEU notes that most NSPs operating in the NEM have quite varying financial structures, often having a much higher gearing than the BEE yet still are able to attract debt at prices lower than the AER allowance for the BEE. This clearly highlights that despite the assumptions and assertions of TransGrid and ElectraNet, the BEE financial structure is quite conservative and enables NSPs to achieve lower costs of capital than the BEE is granted by the AER and yet exceed the FFO/net debt and other criteria used by rating agencies to assess the risk of NSPs.

This observation supports the CEPA comment in its report that (page7):

> "…caution around the interpretation of ratio guidance should be exercised when this guidance has been given for an actual rather than a notional business…"

The MEU agrees with CEPA that an assessment based in isolation of a single criterion of a credit ratings agency is not a sound approach, especially when trying to convert the rating assessment between an actual operating entity and a notional entity which has no direct comparator operating in the market.

The MEU also notes (and supports) the observation made by the AEMC that there needs to be a clear recognition of the reality a NSP has quite conflicting aims in that it will only invest in its network if the investment meets the requirements of the shareholders yet, in contrast, under the National Electricity Law, the NSP is required to make investments that are in the long-term interests of consumers. For example, an augmentation is proposed in the ISP and then the TNSP develops its own cost in the PACR stage (for net benefit analysis) and then refines this in its contingent project application (CPA). Both of these stages are assessed by the AER who determines the efficient cost of augmentation for inclusion in the RAB. If the TNSP does not accept the AER decision, then either consumers pay an inefficient price for the project or the needed augmentation does not occur.

Further, the AEMC makes a sensible observation, that a NSP should not expect that it will necessarily receive a return acceptable to shareholders on each individual project when such a project is needed to meet the long-term interest of consumers. The NSP needs to accept that consumers (via governments) have granted each NSP a social licence to be a monopoly provider in each region. This social licence reflects the expectation that the NSP will assess the investments made on behalf of energy consumers, **in total,** rather than on a project basis. This is the basis on which the NER are predicated, in that the NSP receives revenue calculated on the basis of its total RAB and not on the sum of individual projects[2].

These concerns are reflected in the AEMC observation (page 33):

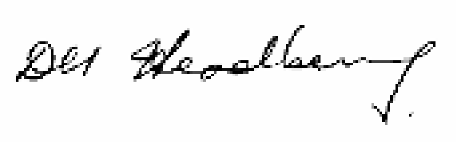
> "While not explicitly stated, TransGrid's argument appears to be that incremental investments in new capital projects need to be attractive to investors on a stand-alone basis, because it is currently open to TNSPs to choose the projects that they will invest in. TransGrid's argument appears to be that a TNSP, behaving rationally, will only invest in new projects such as the PEC where the project itself generates returns on equity that are sufficient for the TNSP's shareholders, regardless of how attractive shareholder returns are on the rest of the TNSP's RAB. According to TransGrid, it is as a result of its cash flow profiles that the forthcoming ISP projects are at risk of not maintaining an investment grade credit rating with a 60 per cent gearing level and consequently they may be value diluting and so may not be attractive to investors."

The MEU agrees and highlights the interesting dichotomy that has not really been addressed in the regulatory framework that operates in the NEM – how are these two potentially opposing views (Ie shareholder interest and consumer interest) are managed when, as noted above, it has been previously determined that each monopoly NSP has an exclusive geographical area to provide network services. Should the shareholders of the NSP have a greater say in the development of the network than the consumers whose long-term interests are to be the determining factor? As noted above, the social licence determines there has to be a balance.

The MEU notes the observation included in the draft decision that the AEMC sees that the proposed rule change regarding financeability has introduced other aspects of efficient and timely delivery of large projects that should be addressed, including a deeper examination of network financing along with regulation and governance issues. The MEU agrees and supports such a review as the MEU has, in addition to the issue noted above, identified other serious issues of concern (such as the impact of the social licence) affecting the assessment of these large projects that will result in significant long-term costs for consumers and so must deliver significant benefits to justify the very large expenditure for such capital works.

The MEU is happy to discuss the issues further with you if needed or if you feel that any expansion on the above comments is necessary. If so, please contact the undersigned at davidheadberry@bigpond.com or 0417 397 056.

Yours faithfully



David Headberry
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[2] The MEU points out that there will be some projects that generate a lower return than others, with others generating a much higher return, resulting in a balancing of total return across all projects.